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Financial statement fraud risk mechanisms and strategies: the case studies of Malaysian commercial companies

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Abstract

This research examines the potential means available to company managers, auditors and regulators of preventing, detecting and reacting to financial statement fraud. Research is conducted by means of interviews with company managers, auditors and regulators. The findings are, while management integrity and the development of internal systems to prevent fraudulent reporting can help to reduce the probability of financial statement fraud taking place, the nature of financial statement fraud as a crime in which the company is an instrument and not a victim makes it essential that penalties enforced by regulators are used to deter and react to cases where such frauds are detected.

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1. Introduction

Financial statement fraud control has attracted considerable attention and associated response in recent years due to the incalculable collateral damage that could drain the long term success of companies. Financial statement should be seemed as the reliable tool for investors to make investment decision and company's stakeholders to appraise the company's financial performance. Nevertheless, due to a number of the reported financial statement fraud cases, the public confidence in accounting and auditing profession has been eroded and also gives a huge impact to the fraud companies. The UK Fraud Act 2006, based on one element of financial statement fraud, states that "a person is guilty of

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fraud if he breaches any sections listed in subsection (2), which includes (2a) false by representation, (2b) fraud by failing to disclose information and (2c) fraud by abuse of position". In respect to financial statement fraud allegations, section 2 of the UK Fraud Act 2006 is presumably relevant. Fraud in financial statements comprises (1) false numbers or representation, (2) inaccurate information that may relate to fraud by failing to disclose the correct information and also (3) involvement of company's directors or top management. Therefore, it could be charged as fraud due to an abuse of position. The above sections are entirely relevant to financial statement fraud allegations as they involve the falsification of accounts and records, which, ultimately, misleads the financial statement users. In this case, the false financial reporting can be associated with market manipulation through which the manipulation of financial figures is achieved to mislead the company's investors. As a contribution to the body of knowledge this research aims to present recommendations to improve financial statement fraud control in commercial companies. The research also evaluates the current strategies for the prevention and detection of financial statement fraud and the reaction thereto. Based on the experience of two Malaysian commercial companies, the research provides the strategies and mechanism to control in particular, financial statement fraud control.

Financial statement fraud differs from other frauds in the corporate environment in that instead of being the victim or perpetrator of fraud, the company is often the instrument of fraud. This may reduce incentives for companies to control frauds which are perpetrated against third parties, often investors and not against the company itself. In addition, while inside involvement is common and therefore the perpetrators are working within the company's systems, the perpetrators are likely to be in senior management roles and therefore have the power to design or circumvent controls.

A further and consequential difference between financial statement fraud and fraud against the corporation is that financial statement fraud need not have any effect on the corporation's actual business. It is a matter of misreporting business results to outsiders, which can be achieved by intervention at any stage in the record-keeping process, often without affecting the records used for internal reporting and decision making and often by those who are in possession of the full facts and in a position to base business decisions on their knowledge, without being misled by their own false reports. This therefore attenuates the business case for financial statement fraud prevention.

2. Literature Review

The victims of financial statement fraud are typically investors in companies (Teoh, Welch and Wong 1998), particularly investors at initial public offerings (IPOs) where wealth flows directly from investors to the company and become available for use at the discretion of management.

Strategies and controls in relation to financial statement fraud control are a necessity in today's business environment. According to Biegelman (2009), "[a]n ounce of prevention does equal a pound of cure"; therefore, the risk of fraud can be reduced through a combination of prevention, deterrence, and detection measures. According to a recent study by the Association of Certified Fraud Examiners (2012), companies without fraud control have experienced fraud losses of approximately 45% median larger than the companies with fraud controls. In relation to this, it is important for every company to place fraud control, particularly the strategy of prevention, detection and response towards financial statement fraud. The strategy could persuade individuals that they should not commit fraud because of the increased likelihood of prevention, detection and the new punishment. There are two parties involved in controlling financial statement fraud, namely, the regulators of the country and the company itself. These two parties have to play their respective roles in order to mitigate fraud. In addition, the audit committee can be a part of the monitoring mechanism to oversee the integrity and quality of the financial statement process. Johnson (2002, cited in Solaiman, 2006) documents that, 'good legal rules' are one of the important parameters in the development of the securities market. Johnson indicates that securities regulation and accounting best practices are two important mechanisms for combating financial statement fraud.

Financial statement fraud control possibly reduces the impact of financial statement fraud; therefore, it provides efficiency savings to investors. In addition, public awareness towards financial statement fraud control is considered important to reduce financial statement fraud cases. However, the study of insurance fraud in Nigeria indicates that the little concern of fraud issues by public has created a worse problem in managing fraud control in Nigeria (Yusuf and Babalola, 2009). Albrecht (2003, 2005) notes that 'financial statement fraud causes a decrease in market value of stock of approximately 500 to 1,000 times the amount of money'. In one case, a \$7 million fraud caused a drop in stock value of about \$2 billion. In relation to this, the research found the need for every commercial company to find ways to

mitigate financial statement fraud. In relation to financial statement fraud control measurement, the research found that improvements in governance are possibly effective in reducing financial statement fraud cases in Malaysia. Transparency of financial reporting and accountability of company management towards financial statement fraud control are two important principles that help to reduce financial statement fraud in all organizations. As previous financial scandals have established, a lack of transparency and accountability create the incentive for top management to commit fraud (Gilsinan et al., 2008). Considering the contextual fundamentals of corporate culture, top managers are seen as a major cause of corporate crime, thus ethical top management possibly reduces corporate crime, particularly in relation to financial statement fraud (Clinard, 1983). In this case, control among the top management is found to be important in reducing the case of financial statement fraud in commercial companies.

Albrecht (2002) also proposes that fraud policy should be one in which the tone is set at the top and that it must be clear that the rules will be applied to all employees, including management. In addition, Farrell and Franco (1999) highlight the responsibilities of management for creating the anti-fraud programmes and controls. According to the auditing standard, SAS 99, auditors and management have the ultimate responsibility for establishing the controls and procedures to protect the organization's assets. The most important elements consist of (1) creating and maintaining a culture of honesty and high ethics among the employees, (2) evaluating the risks of fraud, and implementing risk mitigation in relation to the financial statement, (3) and developing an appropriate oversight process by internal and external parties towards financial statement fraud. According to the AICPA (2009), the most effective way to implement measures to reduce wrongdoing is to base them on a set of core values. This will provide a platform upon which a more detailed code of conduct can be constructed, giving more specific guidance about permitted and prohibited behaviour, based on the applicable laws and the organization's values. Hence, management needs to clearly express that all employees will be held accountable for acting within the organization's code of conduct. The document should identify the measures an organization should take to prevent, deter and detect fraud. However, Dion (2008) suggests that the corporate codes of ethics are not sufficient to strengthen the ethical behaviour due to the lack of self-evidence to identify the right things and perceive rationalization. In order to strengthen the ethical behaviour among the company individuals, the company is supposed to close or minimise the opportunity and rationalization of people to commit financial statement fraud.

The audit committee should be viewed as a value-added oversight function as required by the United States Securities and Exchange Commission. The enactment of SOX 2002 is expected to improve the independence, objectivity, and effectiveness of the audit committee. The empirical studies have suggested the need for independent members of the board of directors (audit committee) to have sufficient financial expertise in scrutinising the financial information (Goldschmidt, 2004; Jayasuriya, 2006). In another response to financial statement fraud in the United States, the FBI sought expanded cooperation with the Certified Public Accountants (CPA) in fighting corporate fraud. The FBI believed that the roles, the independence and the integrity of CPAs are uniquely suited to the partnership. Thus, the CPAs will be the third party expert witnesses and eyewitnesses for the FBI. The mode of cooperation will be dealt with in the way of (1) handling the scope of the problem, (2) identifying common accounting schemes, and (3) working effectively under the impact of the SOX 2002 and related rules and regulations. In relation to the company's action, research by Chen, Kelly and Salterio (2006) suggest that a large number of outside directors would contribute to control financial statement fraud in the company. A large proportion of outside directors would be helpful in monitoring the firm's activities and deterring company fraud. Specifically, Beasley (1996) refers to the outside directors as all non-employee directors. He suggests that the longer the tenure of directors in the company, the better the control and mitigation of financial statement fraud would be. Beasley (1996) supports this argument noting that he had located a company with a large proportion of outside directors with longer tenure and that the company experienced a lower level of financial statement fraud. Dechow, Sloan and Sweeney (1996) add that directors or chairmen with shorter tenure have less company experience and therefore, they are unable to deter fraud in the company. Furthermore, Fama and Jensen (1983) recommend that outside directors should increase their monitoring tasks. Therefore, they would not plot with top managers to confiscate the shareholders' wealth. Fama and Jensen (1983) also discuss what is expected from the external directors. They are supposed to be (1) decision experts, (2) understand the importance of decision control, and (3) able to work with the decision control system in a company.

The board of directors is possibly the most effective internal control mechanism to monitor the actions of top management. Beasley (1996) found that board composition plays a greater role in controlling financial statement fraud.

He also reported that the accounting regulators and standard setters recognize the importance of directors as one of the internal control mechanisms for the prevention of financial statement fraud. For example, two reports from the American Institute of Certified Public Accountants (AICPA) contain recommendations for board independency to mitigate financial statement fraud in a company. Dechow et al. (1996) suggests that the establishment of an internal governance process in every company will be a part of the internal control process in relation to financial statement fraud. The purpose of this is to maintain the reliability of financial statements by controlling manipulation activities. Alternatively, Rezaee (2002) suggests that the executives' compensation packages (stock options and bonuses) should be eliminated, thus financial statement fraud could be prevented in the companies. In this case, the companies' shareholders should be given proper authority to approve the executive compensation packages to avoid fraud within a company. Rezaee (2002) also suggests a practical monitoring mechanism to control financial statement fraud. This includes direct oversight functions by the board of directors, the audit committee, external auditors, and regulatory agencies. Therefore, the effective role and responsibility of the board of directors in the company should be set to the "tone at the top" and they should not tolerate any misstatements in financial statements. In addition, indirect overseeing functions by a company's owner/investor, analysts, institutional investors, and investment bankers should also be a part of the monitoring mechanism.

The effective internal control structure and audit functions are found to be important mechanisms for controlling financial statement fraud. NCIR (1987) documents that the management is responsible for designing adequate and effective internal controls in the financial statement process. The internal auditors and external auditors have to ensure that the internal controls designed are adequate and effective in preventing and detecting financial statement fraud. In relation to this, internal auditors are responsible for assisting management to design, maintain, and monitor the internal controls system. In the meantime, external auditors have been considered as having the responsibility to detect any material misstatements in the financial statements. Auditors are also expected to be independent in their social role, which will contribute to the accountability of corporate management, and therefore, increase the value of the reported financial information issued by the company management. However, audit practitioners are considered to have failed in their ethical duty if they do not make use of safeguarding mechanisms, such as whistle-blowing, and perform their role as expected by the audit profession (Alleyne, Hudaib and Pike, 2013).

In relation to the effect of internal controls on quality of information in financial statements, Altamuro and Beatty (2010) found that improved internal controls did lead to an improvement in financial reporting. However, this was in a context of a risk of biased optimistic or pessimistic reporting rather than thoroughgoing fraud.

The role of external audit in financial statement fraud prevention is crucial. Ball and Shivakumar (2008) found that reporting immediately prior to IPOs was more conservative than at other times and attributed this to heightened audit attention, while Chen, Kelly and Salterio (2012) found that managers who were in a position to falsify figures in accounts were less likely to do so if they learnt of external audit actions designed to prevent this. However, external auditors cannot always be relied on to detect financial statement fraud, as they have only limited resources to do so. Moreover, external auditors tend to see it as being beyond the scope of their work to detect fraud in general (Humphrey, Moizer and Turley, 1993) and may, by extension, be tempted to view fraud detection as not being part of their job at all. Moreover, in countries such as the UK, it is very difficult for investors to sue an auditor, because the investor has no immediate relationship with the auditor, except where additional circumstances have caused such a relationship to arise (as in *ADT Ltd v BDO Binder Hamlyn* [1996]) and because neither the audit opinion nor the financial statements contain any investment advice (*Candler v Crane, Christmas and Co.* [1951], *Caparo Industries plc v Dickman* [1990]).

3. Research Objectives

This research examines the question of what measures can be put in place to control financial statement fraud and its effects. It examines three questions:

1. What measures are presently taken to prevent financial statement fraud?
2. What measures are presently taken to detect financial statement fraud if it occurs?
3. What responses are made to financial statement fraud if it is detected?

4. Methods

The research was conducted by means of semi-structured interviews with interviewees drawn from the management of two industrial companies in Malaysia, one interviewee each from four Malaysian regulatory bodies, two interviewees (one auditor and one forensic accountant) from each of two large audit firms and one representative from an independent company management. The interviews were conducted in Malaysia between 2009 and 2012.

5. Results and recommendations for anti-fraud programme: the strategies of prevention, detection and response in relation to financial statement fraud

The research offers insights into the importance of having an anti-fraud programme, in particularly the prevention, detection and response strategies of financial statement fraud in response to a review of the guidelines for Managing the Business Risk of Fraud. The research suggests that the design of the anti-fraud programme should focus on three main elements: 1) financial statement fraud risk mechanism, (2) financial statement fraud risk evaluation, and (3) financial statement fraud risk responsiveness. The focus on these three elements is significant to ensure that sufficient control for financial statement fraud is incorporated in the designed anti-fraud programme.

5.1 *Financial statement fraud risk mechanism*

The financial statement fraud risk mechanism aims to provide details of the programme designed to ensure the adaptability and compliance of the programme. In relation to this, the research includes three strategies of prevention, detection and response in relation to financial statement fraud that are supposed to be matched with the nature of the business, organizational structure and the whole system of the organization. To achieve this, the research integrates all the research findings in recommending the anti-fraud programme, in particularly the prevention, detection and response strategies in relation to financial statement fraud. To be an effective anti-fraud programme, the three strategies designed should be well distributed across the company to ensure every individual in the organization comprehends the process of the strategies and their own roles and responsibilities. Once a clear explanation is provided in the programme, the company has to focus more on financial statement fraud evaluation and responsiveness. The research further elaborates the recommended three strategies of prevention, detection and response in relation to financial statement fraud as financial statement fraud control in commercial companies.

5.1.1 *Prevention strategies*

Prevention strategies should be supported from both the internal and external environments. The prevention from the internal environment is gained from the prevention strategies designed by the company management and the prevention from the external environment is achieved from the regulators and the relevant independent bodies. The following seven prevention strategies are found to be effective in financial statement fraud prevention in an organization:-

i. Values of honesty and integrity

The first prevention strategy concerns the values of honesty and integrity, particularly among the top management. Even though these values cannot be legislated or measured by the company, these could be cultured in the organization beginning with the process of recruitment and on-going training across the company. The values of integrity and honesty are important to build a strong tone at the top. The strong tone at the top could be achieved through the independent selection of company directors. Therefore, the nomination committee plays an important role in ensuring that the company directors are appointed accordingly. Once the tone at the top has been established in the organisation, the company will perhaps be able to culture the values throughout the organisation.

ii. Specific internal control over financial statement

The second financial statement fraud prevention strategy identified is specifically through internal control over the financial statement. The control designed should be considered in each accounting process and identification of any potential financial statement fraud risk should be made. In this case, the company needs to identify the indicator or red flag that might exist in each accounting process. The control should be designed by the chief financial officer and approved by the audit committee.

iii. Assessment of internal control over financial statement

The third prevention strategy relates to the second strategy. It is suggested that the company hire an external auditor to assess the effectiveness of the internal control design for the financial statement process. Although the process might incur additional cost, the company has to measure this against the huge impact of financial statement fraud.

iv. Participation of internal auditor in financial statement auditing

The fourth strategy is the involvement of the internal auditor in financial statement auditing, as discussed in the above paragraphs. Internal auditing of the financial statement in public companies would not incur additional cost. However, the company has to ensure the competency of the internal auditors in accounting and auditing of financial statements.

v. Greater role of board audit committee

The sixth prevention strategy of financial statement fraud has been found in the role of the audit committee. The role of the audit committee is important in financial statement fraud control. The committee acts as the independent body of the company to oversee the integrity of the financial statements and the internal control designed. The proactive role of the audit committee in overseeing the financial matters is highly significant in financial statement fraud control. The experience and the competency of the audit committee contribute to effective overseeing of the reported financial statement. Therefore, they have to pick up and deal with any issue raised by the external auditors.

vi. Financial statement fraud risk management

The seventh prevention strategy pertains to financial statement fraud risk management. Every company needs to design a specific risk management programme to control financial statement fraud. As the internal control over the financial statement has been designed in relation to the financial statement process, the financial statement fraud risk management programme is supposed to cover the four elements of governance, people, methods and practice. The internal control over the financial statement and the financial statement fraud risk management programme supposedly covers the accounting system and the non-accounting system.

vii. Effective corporate governance

The eighth prevention strategy of financial statement fraud complements all the other prevention strategies with effective corporate governance among the board of directors. The practice of corporate governance, specifically in Malaysia, is not compulsory for public companies unless the public company has been listed on the stock exchange. Listed public companies are required by Bursa Malaysia to report their corporate governance practice which gives assurance to the company's stakeholders. The effective practice of corporate governance would be achieved through the combination of good structure of company's board of directors and a strong tone at the top. The independent conduct of company directors that create the strong tone at the top would prevent financial statement fraud from the top management.

5.1.2 Detection strategies

The research findings indicate that conventional detection methods are commonly found from whistle blowing and hotlines. In addition to these detection procedures, the internal auditing and external auditing are expected to detect fraud in financial statements. In relation to this, the research suggests that the companies consider the detection tools and software, as initiated by previous research through data mining techniques (Bose and Mahapatra, 2001), Multiple Discriminant Analysis (Altman, 1968), Financial Statement Fraud Ontology (Dillon and Hadzic, 2009) and Benford's Law (Durtschi, Hillison and Pacini, 2004). The research also enables the companies to clearly describe what constitutes financial statement fraud to assist the individual in reporting the misconduct. In addition, the informers should be highly protected. The research also suggests the availability of whistle blowing and hotline channels to directly report to the Securities Commission. Therefore, any perpetration by high level company management would be controlled and mitigated.

5.1.3 Response strategies

The research suggests four actions that should be taken by the companies in their response strategies. Firstly, the board of directors have to give priority to the issue of financial statement fraud in board meetings. To implement the antifraud programme, the board needs to establish the fraud committee that consists of independent directors and dependent directors. The role of independent directors is found to be important in the case of the involvement of company directors in financial statement fraud. Secondly, the fraud committee should plan the response procedures in any case of financial statement fraud. The fraud committee is accountable for providing the fraud reporting channel until the prosecution process, through which the perpetrators of financial statement fraud will be dealt in accordance to the company's fraud policy and the necessary disciplinary action before legal action is taken. Thirdly, the research suggests that the board of directors establish a fraud investigation committee. The committee would be responsible in investigating the reported cases, examining the causes of fraud, identifying the breach of financial statement process control, and suggesting the improvement of the identified control. Fourthly, the research promotes the appointment of forensic accountants to deal with the financial statement fraud investigation. Forensic accountants are expert in auditing, accounting and investigative skills pertaining to accounting fraud, particularly, and financial statement fraud. The research found that the anti-fraud programme is significant in controlling financial statement fraud cases in public companies. The strategies designed reflect the non-tolerance of any financial statement fraud case in the company and show that the companies have responded to financial statement fraud appropriately and in a timely manner.

5.2 Financial statement fraud evaluation

The research considers financial statement fraud risk evaluation as an important system to evaluate the potential risk of financial statement fraud. The company management has to identify the exposure of financial statement fraud risk for each financial statement process. The identified exposure should be evaluated periodically through which the financial statement fraud schemes would be identified. The schemes for prevention of financial statement fraud might exist in a variety of departments, places and groups of population in the company. In relation to this, each company has to focus on the identification of financial statement fraud perpetrators and how they exploit the system and hide the fraud.

5.3 Financial statement fraud responsiveness

In addition to the financial statement fraud risk mechanism and evaluation, the research considers that the responsiveness of financial statement fraud risk is significant to ensure that the entire management is adhering to the programme designed. Therefore, the commitment from the company individuals should be done through the affirmation process. The affirmation process should be signed by the employees to affirm their understanding concerning the controls designed. In another effort to show the responsiveness, the conflict of interest disclosure should be signed by the company management. The responsiveness of this anti-fraud programme can be achieved through the monitoring process by the company management together with the internal and external auditors. The monitoring process should

also focus on the reporting procedures and risk management programme.

6. Conclusion

The research contributes to the study of financial statement fraud. The research also contributes new knowledge to the practical control of financial statement fraud, which requires an effective financial statement fraud risk mechanism and strategies. The research offers anti-fraud programmes, particularly in respect of the prevention, detection and response strategies as part of a company's efforts to mitigate financial statement fraud. External controls are gained from the participation of regulators to increase the imposed penalties and charges of financial statement fraud. The findings of this research are consistent with those of Iburgüen and Ayala (2006) who suggested that new government regulations and severe penalties for the fraud perpetrators are one approach to generate reliable financial information and to rebuild trust in the capital market institutions.

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